Microlending Is Latest Trend in Business Assistance

Business loans are projected to grow for the largest loan guarantee programs. Microlending, however, is a new and important trend, and the largest percentage increase in projected loans is in the Small Business Administration's microlending program.

Many sources of financing are available for small businesses. According to recent studies, commercial banks are the main source of small business funding; other sources include venture capital, finance companies, brokerage companies, insurance companies, and other financial institutions. For very small businesses, personal equity or credit cards often provide needed financing, and some businesses rely almost entirely on noncommercial financing provided through not-for-profit organizations. In terms of location, most small businesses acquire their needed capital from small local financial institutions. Local institutions, private and nonprivate, are believed to have an advantage in acquiring needed information about the economic viability of the business and, thus, can better assess the risk and financing needs of the business.

The larger Federal business assistance programs have adapted over the years to this borrower-lender structure and predominately function to reduce financial risk for lenders, through loan guarantees, and, thus, increase access to needed capital for high-risk borrowers. In those cases where businesses are startups or where information gaps preclude lenders from properly assessing loan potential, Federal programs provide more direct sources of debt and venture capital. However, these programs are increasingly offered through third-party, not-for-profit intermediaries and are usually offered in conjunction with additional programs that support increasing the human capital of the borrower.

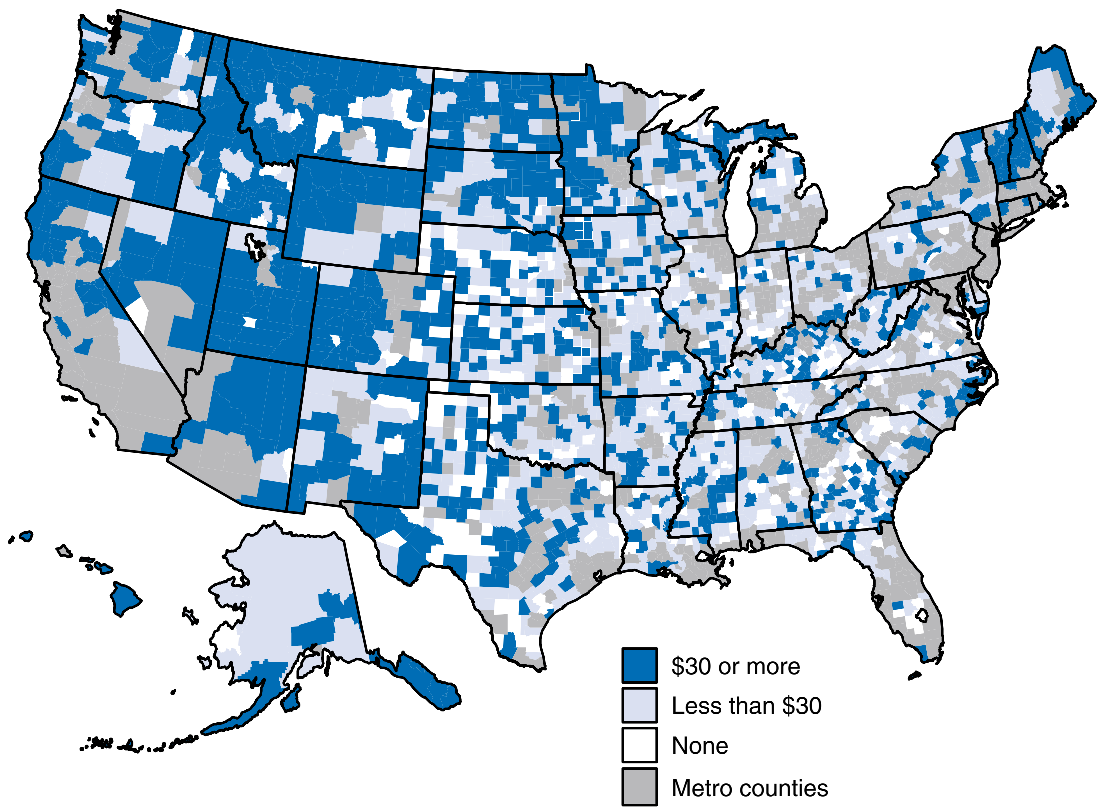
Demand for small business assistance may have declined recently because potential entrepreneurs are being attracted to job opportunities in existing businesses that are participating in the strong growth in the national economy. According to data from the National Federation of Independent Businesses (NFIB), fewer new businesses are being launched. Despite an abundance of credit and other bright economic conditions for startups—not to mention the success stories about young entrepreneurs striking it rich—the number of businesses started in the United States is on the decline. A recent study by the NFIB found that business starts fell 4 percent in 1997 on top of a 14-percent drop in 1996. Preliminary figures for 1998 point to a third consecutive decline. In all, 2.9 million businesses were launched in the United States in 1997 compared with 3.5 million in 1995. However, the NFIB study shows that, while fewer businesses are being launched, fewer small businesses are failing as well. Only 1.3 million small businesses folded in 1997, down from 1.6 million in 1996.

Of the 2,276 nonmetro (rural) counties, the highest level of per capita business assistance in 1997 was in the West, North Central, and New England regions (fig. 1). There were 332 nonmetro counties that received no assistance. The largest single business assistance program continues to be the Small Business Administration's (SBA) 7(a) guaranteed lending program, dwarfing all other programs in terms of dollars appropriated and loans made as a result. But, more interesting than the large, higher profile programs, are the smaller ones that offer funding to microenterprise or very small businesses. These microenterprise programs are of interest because of their possible positive effects on welfare-to-work efforts and on providing the very poor and the unemployed a foothold on the economic ladder. The most recent data available suggest that approximately 13.7 percent of the population, or more than 36 million individuals, live in poverty. Of the total population, 5.2 percent were unemployed over the past 2 years. The microenterprise programs that help these low-income and unemployed populations are often funded through revolving loan funds.

Microenterprise Lending Is a Relatively New Phenomenon

The Small Business Administration (SBA), USDA's Rural Business-Cooperative Service (RBS), and Commerce Department's Economic Development Administration (EDA) are

Figure 1
Per capita Federal nonmetro business assistance, fiscal year 1997
Business assistance was greatest in the West, North Central, and New England regions



Source: Calculated by ERS using Federal Funds data from the Bureau of the Census.

each directly or indirectly involved in development financing's latest trend. SBA has its section 7(m) Microloan program which utilizes community based nonprofit lending and training organizations across the country. RBS has its Intermediary Relending Program (IRP) that funds Revolving Loan Fund's (RLF's) making microloans, and EDA's Economic Adjustment Program (EAP) also supports RLF's making microloans. Microloan activity is also being supported by ACCION International in four major metropolitan areas, and other intermediaries have various levels of microloan activity underway.

What is microlending? Microloans are typically smaller than $5,000 per loan, although SBA's Microloan program will make loans up to $25,000. Typically, microloans are too small to be economically viable for traditional banks to make. These loans are usually targeted at individuals who have economically valuable human capital, but lack the necessary money or credit to buy physical assets needed to start or expand a business.

Microcredit or lending began in earnest in 1983 in Bangladesh, India. What began as an experiment has grown into a multibillion dollar lending mechanism used in many developing countries. In the last 7 to 8 years, various attempts have been made to transplant the financing technology to the United States.

International experiences have taught us important lessons over the years. The most important is that capital access is the main issue, not capital cost. All successful microloan programs have charged above-market interest rates that appropriately reflect risk. However, in most cases, the lenders have remained dependent on other outside sources of funding to cover overhead and management expenses. Loan default rates have been kept low by using peer lending groups in lieu of traditional forms of collateral.

Microloan programs tend to be most successful in areas with a large pool of prospective borrowers who have undercapitalized labor skills. If individuals must sell their skills at near zero prices because someone else controls essential elements of production or distribution, then giving them access to capital to overcome a real credit constraint can empower these individuals and provide very positive returns to both labor and capital. Couple that with training to improve production methods and financial management, and positive things happen.

Studies indicate that rates on microloans need to be high enough to cover the costs of loanable funds plus overhead. In the United States, however, many programs are still funded by loans with subsidized interest rates, such as the IRP's 1-percent loans. This high-interest subsidy cost reduces the number of high-risk loans that can be financed with a given level of program budget authority.

Largest SBA Programs Projected To Grow in 1999

The Small Business Administration (SBA) provides the largest amount of business loans, most of it through its two largest programs, the section 7(a) and the section 504 programs (table 1). Use of SBA's section 7(a) guaranteed loan program declined last year after having increased dramatically in prior years. However, SBA projects that this program will grow in 1999.

The 7(a) program provides loans to small businesses unable to secure financing on reasonable terms through normal lending channels. The program operates through private-sector lenders that provide loans, which are, in turn, guaranteed by the SBA. In 1992, SBA made or guaranteed approximately 24,000 loans totaling about $5.9 billion. In 1998, SBA approved over 42,000 loans totaling over $8.5 billion, down slightly from 1997, when SBA financed 45,000 loans totaling $9.5 billion. The decrease may reflect the robust economy's pull on potential small business entrepreneurs.

In 1997, nonmetro areas received $19.45 ($24 in 1996) in per capita small business 7(a) guaranteed assistance, somewhat less than the $27 (no change) received in metro areas; the nonmetro areas that benefited most were in Southern counties not adjacent to metro areas and in counties specializing in services and farming.

Activity in the SBA's large section 504 Certified Development Company (CDC) program has also grown. A CDC is a nonprofit corporation set up to invest in the economic development of its community or region. CDC's work with the SBA and private-sector lenders to provide growing businesses with long-term, fixed-rate financing for major fixed assets, such as land and buildings. There are about 290 CDC's nationwide. Each covers a specific area.

In 1992, this SBA program provided for about 2,000 business financings totaling nearly $560 million in loans. By 1998, those figures had increased to 4,930 financings and $1.8 billion in loans. SBA projects this program will increase its activity level again in 1999.

Metro areas tend to benefit more from this program than nonmetro areas. In 1997, nonmetro counties on average received just over $4 per capita in 504 loan guarantees compared with nearly $6 per capita in metro counties.

In contrast to these two large loan guarantee programs, the smaller disaster direct loan program is projected to decline in 1999. This could change, however, if new disasters result in supplemental disaster loan funding later in the year.

In 1998, SBA continued to increase its service to minority and women borrowers. To increase capital access for those small businesses that have had unusually difficult times obtaining financing, SBA expanded the pre-qualification loan program. Pre-qualification is performed by selected nonprofit and for-profit groups working with small business loan applicants one-on-one to develop viable business plans and loan packages. Once SBA

Table 1

Federal funding for selected business assistance programs by fiscal year[1]

Most business loan guarantee programs are expected to increase their loan activity in 1999

Program	1998 actual	1999 estimate	Change	Rural areas most affected by the program[2]
	Billion dollars		Percent	
SBA 7(a) business loan guarantees	8.50	10.50	23	Service counties and counties in West
SBA Certified Development Loan Company guarantee (section 504)	1.80	3.00	66	Service counties and counties in West
SBA disaster loans	.64	.40	-37	Places experiencing disasters
RBS Business and Industry loan guarantees (B&I)	1.2	1.0	-16	Manufacturing counties and counties in the West
RBS Intermediary Relending Program	.04	.03	-6[3]	Nonspecialized counties and counties in West
RBS Rural Business Enterprise Grants (RBEG)	.04	.04	0	Manufacturing counties and counties in South
EDA Economic Adjustment Grants[4]	.03	.03	0	Government and poverty counties and counties in the South

Note: SBA = Small Business Administration; RBS = Rural Business-Cooperative Service, U.S. Department of Agriculture; EDA = Economic Development Administration, U.S. Department of Commerce.

[1]Budget authority used for grant programs; projected loan levels (obligations or program level) used for loan programs. Note that, in some cases, budget authority may be falling at the same time that projected loan obligations are rising. This can happen for any number of reasons, including making use of greater efficiencies, reducing subsidies, charging fees, and using unobligated balances of funds from prior years.

[2]See appendix for rural area definitions.

[3]Loans are projected to decline from $35 million to $33 million, but budget authority remains constant.

[4]This represents just part of the larger EDAP program (see text); many of these grants are used to support revolving loan funds that issue loans to businesses; hence, a larger number of loans will result than indicated by this budget authority amount.

Source: *Budget of the United States, Fiscal Year 1998*.

finds the borrower to be eligible and creditworthy, it issues a pre-qualification letter to lenders indicating that the application appears appropriate for an SBA loan. The borrower then takes the entire package to a lender.

SBA originally launched a Women's Pre-Qualification Loan Pilot Program in June 1994. During the pilot, more than 2,220 pre-qualification loan applications were prepared and submitted to SBA. Of those, 1,460 received SBA commitment letters and more than 1,100 received SBA guaranteed loans. Of those, 818 loans valued at $80 million were for women, and 284 loans, valued at $32 million, were made to minority-owned firms. In addition, SBA provided $700,000 to enhance the Tribal Business Information Center

Program, as well as other initiatives to improve Native Americans' access to capital markets. SBA also continues to increase its targeting of the 7(a) and 504 programs to African American entrepreneurs. For example, in fiscal 1997, SBA provided 1,903 guarantees valued at $286 million to African American borrowers.

USDA's Largest Business Assistance Program Is Also Projected To Grow

The main business assistance programs of USDA's Rural Business-Cooperative Service (RBS) are the Business and Industry (B&I) program, the Intermediary Relending Program (IRP), and the Rural Business Enterprise Grants (RBEG) program. Unlike other Federal business assistance programs, RBS's programs target rural areas. Generally, RBS programs are available to communities with less than 50,000 population; in the case of the IRP, city populations are limited to 25,000. Also, RBS still maintains direct lending programs that are targeted to the poorest of counties.

Between 1993 and the end of fiscal year 1998, RBS approved 2,623 guaranteed B&I loans totaling over $3.4 billion and averaging $1.3 million. Over the 5-year period, B&I loans increased by almost 250 percent. RBS approved 803 loans in fiscal year 1997 for $1.2 billion. While guaranteed loans were approved for borrowers in every State, the largest number of loans went to California, Florida, and North Carolina, where more than 400 loans for over $508 million were approved. In fiscal 1997, per capita funding to rural counties was $9 compared with $19 for the SBA's 7(a) program. The subsidy costs for B&I loans was about 1.3 cents per dollar of loan.

RBS's IRP is an important source of capitalization for rural revolving loan funds. In 1998, RBS issued a revised rule for the IRP, to more clearly define the respective roles of the government and intermediaries, make the program more responsive to the needs of intermediaries and ultimate recipients, and facilitate the creation of rural jobs. Specific changes of note were (1) intermediaries with a delinquent outstanding Federal debt are ineligible; (2) eligibility requirements for ultimate recipients are provided; (3) eligible purposes are increased to include fees and existing debt refinancing; (4) responsibility for maintaining and managing the revolving fund are clarified along with a requirement for establishing a reserve for bad debts; and (5) USDA's State Rural Development offices are authorized to process applications rather than send them to the national office.

In recent years, Minnesota and Oregon together accounted for 51 of 315 loans made since 1993, for an estimated $50.9 million. This program's fiscal 1997 per capita funding in rural counties was $0.43. Subsidy costs for the IRP were high over this period, running about $154 million. The subsidy costs represent most of the total costs for these loans, reflecting the high-interest subsidy rate for IRP loans. Specifically, IRP loans are made at 1-percent interest, which is far below the agency's cost.

In 1997, USDA financed the startup and expansion of about 659 rural businesses and cooperatives, which created over 29,400 jobs. USDA also guaranteed over $815 million in loans. Since 1985, the losses of the B&I program have remained constant at nearly 4 percent of the total amount loaned. In fiscal year 1997, one new job was created, on average, per every $253 in USDA B&I investment subsidy. RBS estimates that $1 billion in guaranteed loans creates or saves about 40,000 jobs.

In 1998, RBS cosponsored a forum on how to increase the reach of microenterprise development in rural areas. This increase in activity would likely come through targeting IRP funds for microenterprise Revolving Loan Funds.

EDA's Economic Adjustment Program Was Reauthorized

Commerce Department's Economic Development Administration (EDA) won a long-fought battle in 1998 as lawmakers voted to reauthorize the agency for the first time since 1982. EDA's Economic Adjustment Program (EAP), which supports revolving loan funds, remains basically the same, as do its funding levels of roughly $33 million annually. Only about 10 percent of the money is actually used to capitalize revolving loan funds that actually make small business loans. One evolutionary change is the requirement that grant recipients file somewhat more stringent financial performance reports for the revolving funds. Evaluations will focus on management standards, financial accountability, and program performance. (EDA's reauthorization is discussed in more detail in the article on General Assistance.) *[George Wallace, 202-694-5369, gwallace@econ.ag.gov]*